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Prioritization and Mutualization: Clearinghouses and the Redundancy of the Bankruptcy Safe Harbors

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PRIORITIZATION AND MUTUALIZATION: CLEARINGHOUSES AND THE REDUNDANCY OF THE BANKRUPTCY SAFE HARBORS

*Adam J. Levitin**

ABSTRACT

This Article argues for the repeal of the bankruptcy safe harbors for financial contracts because they are redundant systemic risk safeguards. Most systemically important types of financial contracts now clear through clearinghouses. Clearinghouses are a superior method to the safe harbors for protecting the liquidity of systemically important money substitutes and do not subordinate bankruptcy policy concerns to systemic risk concerns. Clearinghouses are a better guaranty against systemic disruption than the safe harbors because they can absorb the losses caused by insolvencies and fire sales due to their deep capital and lack of leverage. Moreover, clearinghouses reduce systemic risk by forcing internalization of systemic externalities on the finance industry through loss mutualization. This reduces the industry's incentive to engage in excessively risky transactions. And, in the event that losses overwhelm clearinghouses, they are technically and politically easier to bail out than individual firms when the safe harbors prove inadequate. Accordingly, this Article argues for the safe harbors to be replaced with a clearing mandate only for those types of highly liquid financial contracts that serve as money substitutes.

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INTRODUCTION

When a firm fails who will bear the losses? Two basic methods of loss allocation appear in a variety of insolvency systems: prioritization and mutualization. Prioritization places creditors in a senior-subordinate priority structure that concentrates losses on a subset of the junior creditors, leaving the senior creditors unimpaired. Mutualization, in contrast, eschews a priority structure and allocates losses on a pro rata basis.

United States bankruptcy law allocates losses using a mixture of prioritization and mutualization. The starting point of bankruptcy law is that “equity is equality” and indeed, the default loss allocation in the Bankruptcy Code is pro rata distribution among creditors. But the Bankruptcy Code also countenances numerous deviations from this principle. Bankruptcy law prioritizes a range of types of claims in different ways: recognition of contractual priority; provision of statutory priority; recognition of rights in collateral; and exception from the automatic stay and avoidance actions. Among these different types of prioritization, the most extreme is automatic exception from the automatic stay and insulation from avoidance actions.¹ Such treatment allows a creditor to seize collateral or exercise setoff rights to satisfy its claim through closeout netting.² Because these hyper-prioritized creditors are not subject to the automatic stay, they get first “dibs” on the debtor’s assets, while other creditors have to wait in line and then fight for the remaining scraps.

This extreme prioritization is granted only to one category of claims: financial contracts. Swaps, repos, securities contracts, forward contracts (including both contracts for physical delivery and commodities futures), and master netting agreements are all types of financial contracts that are exempt from the automatic stay, at least for purposes of accelerating, terminating, and liquidating the claims.³ These types of financial contracts are also exempt from most avoidance actions, so transfers made to the debtor’s counterparties under these contracts cannot be clawed back into the bankruptcy estate as voidable preferences or constructive fraudulent transfers.⁴

The standard policy justification for the special treatment of financial contracts is that impairment of these contracts poses a systemic risk because

1. The automatic stay, 11 U.S.C. § 362(a) (2012), is a cornerstone of bankruptcy law that enjoins most attempts to collect from the bankruptcy estate outside of the bankruptcy process. Bankruptcy law also permits the avoidance of certain pre-bankruptcy transfers of the debtor’s property. *See* 11 U.S.C. §§ 544, 547–548.

2. Closeout netting is the process of netting out the transactions between a defaulting firm and a nondefaulting firm into a single net payment. Closeout netting reduces the nondefaulting firm’s credit exposure to the defaulting firm from gross exposure to net exposure.

3. 11 U.S.C. §§ 362(b), 555–557, 559–561.

4. *See id.* § 546(e)–(g), (j).

of the interconnected nature of the financial system.⁵ According to this argument, imposing delays on payment or allowing the debtor to cherry-pick which contracts to perform—as would occur without the special treatment for financial contracts—would pose liquidity and even solvency threats to the debtor’s counterparties and roil financial markets.⁶

Existing scholarship strongly criticizes the bankruptcy treatment of financial contracts. Some scholars have questioned whether the special treatment actually serves its intended purpose.⁷ Although the scholarly literature largely accepts the systemic risk reduction benefit of bankruptcy law’s special treatment of financial contracts, the literature criticizes the treatment as poorly tailored, because special treatment covers more than systemically important contracts.⁸ The existing literature points toward a need to narrow the definitions of prioritized financial contracts in the Bankruptcy Code. But implicit in the existing literature’s critique is that special treatment of systemically important contracts *is* merited to the extent that it prevents systemic risk.

This Article departs from the existing literature to argue for the complete elimination of the special bankruptcy treatment for all types of financial contracts. There is a better way to address the systemic stability concerns: mandating the use of clearinghouses as systemic shock absorbers for those types of transactions that function as money substitutes and thus

5. Edward Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 660 (2005).

6. See, e.g., David Mengle, *The Importance of Close-Out Netting* 4–5 (ISDA Res. Notes, No. 1, 2010), <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf>.

7. See Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 92 (2005) (arguing that safe harbors may actually increase systemic risk by encouraging runs on the debtor); Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319 (2010) (arguing for the repeal of the safe harbors because they actually increase systemic risk by encouraging runs on the debtor); Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011) (arguing that safe harbors increase systemic risk by reducing counterparty incentives to monitor).

8. See Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2009) (arguing for limiting the safe harbors to Chapter 7 cases); Charles W. Mooney, Jr., *The Bankruptcy Code’s Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe Too Safe?*, 49 TEX. INT’L L.J. 245, 254–58 (2014) (arguing for a narrowing of the automatic stay exception and avoidance action safe harbors); Morrison & Riegel, *supra* note 5 (noting the potential overbreadth of the definition of financial contracts); Edward Morrison, Mark J. Roe, & Christopher S. Sontchi, *Rolling Back the Repo Safeharbors*, 69 BUS. L. 1015 (2014) (arguing for limited repeal of repo safe harbors); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 156–57 (2012) (proposing narrower prioritization of certain financial contracts). See also Bryan G. Faubus, Note, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801 (2010). Stephen Schwarcz and Ori Sharon are affirmatively agnostic about the systemic risk reduction benefit, and instead emphasize the path-dependent nature of the treatment of financial contracts. See Stephen L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715, 1753–54 (2014).

raise systemic risk concerns from illiquidity or credit impairment.⁹ Because the money supply is the lubricant of all commerce, any impairment of instruments that function as money threatens broad disruptions in the economy. These impairments undermine confidence in the money supply and thus inject a hard-to-price risk into all transactions, making it difficult for parties to come to terms.

Many types of financial contracts already clear through clearinghouses, which stand in the shoes of their members to formally assume the counterparty payment risk on cleared contracts. Clearinghouses represent an efficient risk transfer mechanism, because clearinghouse capital structures function to aggregate the capital of their members into a mutual firm with much greater ability to absorb losses than any individual member firm. The liquidity and solvency concerns faced by an individual firm upon its counterparty's bankruptcy are simply lesser threats to a clearinghouse.

The use of clearinghouses is not generally required by public law; instead, their use is a private market-driven development. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), however, mandates the use of clearinghouses for most swap contracts.¹⁰ To date, the scholarly literature has not worked through the implication of the Dodd-Frank Act's swap clearing requirement on the treatment of financial contracts in bankruptcy. The Dodd-Frank Act entirely undermines the systemic risk justification for the special bankruptcy treatment of financial contracts by pointing to a better way to address systemic risk, namely mandating the use of clearinghouses for those systemically important classes of contracts. With the use of clearinghouses as a systemic shock absorber, prioritization of financial contracts in bankruptcy becomes redundant and therefore can be eliminated without raising systemic risk concerns. There is no need for a belt-and-suspenders approach to systemic risk when one of the approaches is widely recognized as impeding other important policies and may well be ineffective at reducing systemic risk.

This Article argues that clearinghouse mutualization is a preferable method of addressing systemic risk than bankruptcy prioritization. Mutualization aggregates the capital of the financial services industry,

9. Stephen D. Adams has made a parallel argument that the Orderly Liquidation Authority in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act renders the special treatment of financial contracts in bankruptcy superfluous. Stephen D. Adams, *Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis*, 20 STAN. J.L. BUS. & FIN. 91, 94 (2014). Adams, however, only calls for limiting the special treatment, not for eliminating it, and the regulatory implementation of Title II of the Dodd-Frank Act may well incorporate similar prioritization of financial contracts. *Id.* at 119–20.

10. Dodd-Frank Act, Pub. L. No. 111-203, §§ 723, 763, 124 Stat. 1376, 1682, 1762 (2010) (codified, respectively, at 7 U.S.C. § 2(h) and 15 U.S.C. § 78c-3 (2012)). The U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) are empowered to exempt certain types of swaps from the clearing requirement. *Id.* Derivative-market participants are also subject to capital and margin requirements. *Id.* §§ 731, 764 (codified, respectively, at 7 U.S.C. § 6s and 15 U.S.C. § 78o-8(e) (2012)).

which makes for a much stronger bastion against systemic failures than the capital of any single firm and reflects the interconnectedness of the financial services industry. Mutualization also spreads losses according to the scale of risk-producing activity, thereby forcing an internalization of systemic externalities.

Accordingly, this Article proposes a discrete set of policy reforms: first, elimination of all special treatment in bankruptcy for all financial contracts; second, requirement of the use of clearinghouses for the subset of financial contracts that are systemically important, the universe of which corresponds with those susceptible to centralized clearing (i.e., highly liquid money substitutes); and lastly, creation of a more robust regulatory system for clearinghouses themselves to ensure that they are a source of strength, not a locus of risk in the financial system. In other words, there should be no safe harbors for any financial contracts, but use of clearinghouses should be mandated for those money-substitute contracts whose liquidity needs to be protected to prevent against systemic shocks.

The remainder of this Article proceeds as follows. Part I introduces the concepts of loss “prioritization” and loss “mutualization” as two alternative approaches to allocating the losses resulting from the failure of a firm, either concentrating losses on a subset of creditors or spreading them among all creditors. As Part I explains, different loss allocation systems emphasize one approach or the other, but typically involve some combination of prioritization and mutualization. In particular, bankruptcy law emphasizes prioritization, while private transaction clearinghouses emphasize mutualization. Part II examines the special prioritized treatment of financial contracts in bankruptcy (safe harbors) that is designed to reduce the systemic risk resulting from firms’ failures. The safe harbors’ effectiveness at reducing systemic risk has been trenchantly questioned, and critics have also observed that the safe harbors are overly broad for their purposes, encourage overextensions of credit, and undermine bankruptcy policy goals of furthering reorganization. Part III points to the Dodd-Frank Act’s swap clearing mandate to argue that clearinghouses perform the same systemic risk mitigation function as the bankruptcy safe harbors for financial contracts, but without the undesirable effects of the safe harbors on credit markets and the bankruptcy process. Accordingly, Part III argues for replacing the safe harbors with a clearing requirement for all classes of systemically important contracts.

I. PRIORITIZATION AND MUTUALIZATION

Firms fail. Failure is an unavoidable fact of business life. A range of private and public regimes exist to address the allocation of losses upon a firm’s failure, depending on the type of firm (e.g., depository, insurance company, credit union, broker-dealer, railroad, or other type of business entity). Some of these regimes concentrate losses on an individual creditor

or creditors (prioritization), thereby ensuring that the failed firm's assets are used to repay the firm's other, prioritized creditors. For example, private-label securitizations feature cash-flow waterfalls that allocate realized losses in a senior-subordinate structure that concentrates losses initially on a first-loss tranche, then, when that tranche is wiped out, on a second-loss tranche, etc. Other regimes spread the losses—and assets available for repayment—among all creditors (mutualization). In its simplest form, the partners in a general partnership will realize losses on a pro rata basis, absent some other agreement.

Prioritization and mutualization have different effects on voluntary creditors' ex ante incentives. In a pure prioritization system, losses are concentrated on some creditors. Those creditors who bear concentrated risk have greater incentives to take care when extending credit because they could potentially bear 100% of the losses. As a result, their risk-adjusted pricing will affect the total amount of credit extended to the debtor.

The flip side of this is that creditors with high priority who are unlikely to bear losses have less incentive to be cautious when extending credit and may overextend credit because the risk is borne first by other parties.¹¹ Accordingly, creditors in a pure prioritization system will price their extensions of credit based on where they fit within the priority structure, but at least for contractual creditors, there are parties properly incentivized to impose market discipline on the debtor. Yet such a prioritization system is poorly suited for a world with involuntary creditors (such as tort victims and tax authorities) and nonadjusting voluntary creditors. In the presence of such involuntary and nonadjusting creditors, a prioritization system will not ensure optimal market discipline on extensions of credit.

Ex ante incentives for disciplined extensions of credit work differently in a pure mutualization system. In a pure mutualization system, creditors' incentives for taking care at the time of extending credit are reduced because losses will be shared with other creditors. Thus, pure mutualization creates a moral hazard that encourages excessive extension of credit. As a result, most loss allocation regimes feature a combination of prioritization and mutualization in an attempt to capture the best qualities of each system of loss allocation.

A. PRIORITIZATION AND MUTUALIZATION IN THE BANKRUPTCY CODE

The default treatment of claims in bankruptcy is one of mutualization. In Chapter 7, all timely filed general unsecured claims are paid on a pro rata

11. These incentives may flip as a debtor's insolvency becomes more likely—the junior creditors who are more likely to end up out of the money may, like equity holders, agitate for higher-risk, higher-return strategies for the debtor, while the more senior creditors may monitor the debtor more closely as it becomes more likely that they will bear losses.

basis.¹² Chapter 11 mandates pro rata treatment within each class of creditors¹³ and requires either a majority vote of each impaired class of creditors or that there be no “unfair discrimination” between classes of creditors.¹⁴ The mutualization norm is reinforced by the automatic stay,¹⁵ which prevents creditors from jumping ahead of others by proceeding with collection outside (or inside) of the bankruptcy court process. Other Bankruptcy Code provisions—such as disallowing unmatured interest,¹⁶ preserving avoided transfers and liens for the benefit of the estate,¹⁷ prohibiting the attachment of security interests to post-petition after-acquired property,¹⁸ and disallowing the attachment of security interests to post-petition proceeds, products, offspring, profits, and hotel and lodging rents and fees¹⁹—all further ensure that some creditors do not jump ahead of others in the bankruptcy process absent a showing of cause and procedural protections.

The various bankruptcy avoidance actions—actions to avoid certain prepetition transfers—also reinforce the mutualization norm. For example, the bankruptcy estate can avoid preferential transfers²⁰ and preferential setoff rights.²¹ Avoidance of pre-bankruptcy preferences emphasizes the idea that equity is equality. A preference is defined as a transfer that enables the transferee to fare better than it would in a hypothetical Chapter 7 bankruptcy than it would fare without the transfer.²² Likewise, the bankruptcy estate can avoid transfers for which the insolvent debtor did not receive reasonably equivalent value,²³ or which were made with intent to hinder, delay, or defraud creditors.²⁴ Such fraudulent transfers enable creditor transferees to do better than if they had dealt with the debtor on arm’s length terms and thus are contrary to the equality principle in the mutualization norm. Similarly, the bankruptcy estate can avoid unperfected transfers under the strong-arm power.²⁵ A general unsecured creditor would not have had notice of such avoidable transfers and would thus not have been able to adjust accordingly. Avoidance of such transfers again reinforces the equality principle.

12. See 11 U.S.C. § 726(b) (2012).

13. *Id.* § 1123(a)(4).

14. *Id.* § 1129.

15. *Id.* § 362(a).

16. *Id.* § 502(b)(2).

17. *Id.* § 551.

18. *Id.* § 552(a).

19. *Id.* § 552(b)(1)–(2).

20. *Id.* § 547.

21. *Id.* § 553(b).

22. *Id.* §§ 547(b)(5), 553(a)(3).

23. *Id.* §§ 544(b), 548(a)(1)(B).

24. *Id.* § 548(a)(1)(A).

25. *Id.* § 544(a).

Yet for all of the provisions in bankruptcy law that create a mutualization background, there is a significant prioritization overlay. First, bankruptcy law recognizes priorities granted by non-bankruptcy law. Thus, creditors' liquidation priority over equity is recognized, as are the liquidation preferences of any preferred equity interests.²⁶ Likewise, bankruptcy law recognizes security interests that are perfected under applicable non-bankruptcy law²⁷ and statutory liens.²⁸ Similarly, bankruptcy law recognizes contractual subordination agreements,²⁹ setoff rights,³⁰ and reclamation rights.³¹ Second, bankruptcy law creates its own federal statutory priorities for certain claims, both pre- and post-petition.³² Third, bankruptcy law creates functional priorities for creditors whose executory contracts and unexpired leases are assumed by requiring cure of monetary defaults prior to assumption.³³ These creditors' prepetition claims get paid in full and prior to the effective date of a plan or a liquidation. Finally, bankruptcy law creates functional priorities for creditors through exemption from the automatic stay³⁴ and avoidance actions.³⁵

Bankruptcy's treatment of financial contracts—swaps, repos, securities contracts, commodities futures contracts, forward contracts, and master netting agreements—is entirely one of prioritization. All of these types of financial contracts (which are defined broadly) are exempt from the automatic stay, at least for purposes of the debtor's counterparties' acceleration, termination, and liquidation of their claims.³⁶ Financial contract counterparties may also offset any collateral posted by the debtor to cover the contract.³⁷ Financial contracts are also exempt from most avoidance actions. Transfers made in connection with a financial contract cannot be avoided as preferences or constructive fraudulent transfers under federal law.³⁸ They may be avoided only as actual fraudulent transfers (that is, when made with actual intent to hinder, delay or defraud creditors).³⁹

26. *See id.* §§ 726, 1129(b)(2).

27. *Id.* §§ 506, 725, 1129(b)(2)(A).

28. *Id.* §§ 545, 546(i).

29. *Id.* § 510(a).

30. *Id.* § 553(a).

31. *Id.* § 546(h).

32. *Id.* §§ 364, 507, 726.

33. *Id.* § 365(b)(1).

34. *Id.* §§ 362(b), 555–557, 559–561.

35. *Id.* § 546(e)–(g), (j). Bankruptcy law also creates functional priorities for consumer debtors through property exemptions, section 522, and for creditors through the discharge exceptions, sections 523, 727, 1328, which encourage repayment of nondischargeable claims.

36. *Id.* §§ 555–557, 559–561.

37. *Id.* § 362(b)(6)–(7), (17), (27).

38. *Id.* § 546(e)–(g), (j).

39. It is unclear whether section 546(e)–(g) and (j) prevents state law fraudulent transfer actions by litigation trusts or creditors' committees acting as representatives of the estate. Courts are split on the issue. *Compare* *Whyte v. Barclays Bank PLC*, 494 B.R. 196, 200 (S.D.N.Y. 2013) (state law fraudulent transfer action brought by litigation trust preempted by section 546(G)), *with In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (state law

Thus, even though the general bankruptcy story is one of mutualization with an overlay of prioritization, for financial contracts the story is solely one of prioritization.

B. CLEARINGHOUSES AS RISK MUTUALIZATION DEVICES

The Bankruptcy Code is not the only loss allocation system that combines prioritization and mutualization that can be found in federal and state statutory receiverships for failed financial institutions.⁴⁰ Financial contracts are similarly prioritized in statutory receiverships by the Federal Deposit Insurance Corporation (FDIC),⁴¹ National Credit Union Administration (NCUA),⁴² Securities Investor Protection Corporation (SIPC),⁴³ Federal Housing Finance Agency (FHFA),⁴⁴ and state insurance commissions.⁴⁵ While this Article is focused on the bankruptcy safe harbors, its arguments apply with equal force to the parallel safe harbors in FDIC, NCUA, SIPC, FHFA, and state insurance company receiverships.

The Dodd-Frank Act takes a different track toward loss allocation than other statutory loss allocation systems. The Dodd-Frank Act propounds a mutualization principle, at least for swaps. Specifically, the Dodd-Frank Act requires most swaps to be cleared through clearinghouses.⁴⁶ As this section explains, clearinghouses serve as a risk mutualization device.

Clearinghouses are a type of financial institution that serve as a central counterparty to transactions. Instead of two counterparties to a contract making payments directly to each other, they each make their contractual payments to the clearinghouse, which has assumed the liability for passing on the payment to the other counterparty. The insertion of the clearinghouse as a central counterparty is done through contract novation. When two members of a clearinghouse enter into a transaction that is to be cleared through the clearinghouse, the clearinghouse is novated into the contract for each counterparty, meaning that it assumes all of the rights and obligations of that contract counterparty. The result is to substitute the payment risk of the clearinghouse for the payment risk of each counterparty to the contract,

fraudulent transfer action brought by Official Committee of Unsecured Creditors not preempted by § 546(e)), and *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (following *Tribune*, 499 B.R. 310).

40. FDIC, NCUA, FHFA, and state insurance regimes.

41. See 12 U.S.C. § 1821(e)(8) (2012) (regular FDIC receiverships); see also *id.* § 5390(a)(11)(F), (c)(8) (Orderly Liquidation Authority receiverships). FDIC Orderly Liquidation Authority includes a very limited stay of the termination, liquidation, and acceleration of financial contracts. *Id.* § 5390(c)(10)(B).

42. See *id.* § 1787(c)(8).

43. See 15 U.S.C. §§ 78eee(b)(2)(C)(i), 78fff(b) (2012).

44. See 12 U.S.C. § 4617(d)(8).

45. INSURER RECEIVERSHIP MODEL ACT § 711 (NAT'L ASS'N. OF INS. COMM'RS 2007). As of the fourth quarter of 2014, relatively few states had adopted the Insurer Receivership Model Act. See *id.* at ST-555-3 to -8.

46. See Dodd-Frank Act, Pub. L. No. 111-203, §§ 723, 763, 124 Stat. 1376, 1682, 1762 (2010) (codified, respectively, at 7 U.S.C. § 2(h) and 15 U.S.C. § 78c-3).

because each counterparty has the clearinghouse as its formal counterparty after the novation, rather than its original counterparty.

For example, suppose bank *A* agrees to sell an asset to bank *B*. When banks *A* and *B* go take that sale contract to the clearinghouse, it is broken into two matched contracts: a contract for bank *A* to sell the asset to the clearinghouse and a contract for the clearinghouse to sell the same asset to bank *B*. Thus, instead of bank *A* assuming the payment risk of bank *B*, bank *A* has assumed the payment risk of the clearinghouse. Similarly, instead of bank *B* assuming the delivery risk of bank *A*, it has assumed the delivery risk of the clearinghouse. The clearinghouse substitutes its own risk of performance for that of each of the counterparties to the contract. For this service, the clearinghouse will charge a fee and may require the members to post collateral (“margin” in clearinghouse parlance). Because many clearinghouses are organized as mutuals—firms owned by their customers—clearinghouses price to cover risk, not to maximize profit.⁴⁷

Formally, clearinghouses clear only their members’ transactions, but functionally they clear transactions not just for their members, but also for their members’ customers. Clearinghouse members will use the clearinghouse to clear not only transactions for their own account, but also transactions for their customers’ accounts, with the member novated into the contract for its customer prior to presenting the contract to the clearinghouse for clearing. This results in two levels of novation. For example, if hedge fund *X* and hedge fund *Y* enter into a swap, each hedge fund will take that swap to its brokerage firm (such as banks *A* and *B* above), which will be a clearinghouse member. Each brokerage will be novated into the swap for its respective hedge fund client and then the brokerages will clear the swap through the clearinghouse. The clearinghouse will not know the identity of the ultimate party in interest on the swap, but will only know that of its members.

Clearinghouses are commonly used in payment systems. The Federal Reserve Board and various private entities all operate clearinghouses for checks, wire transfers, and automated clearinghouse transactions. MasterCard and Visa operate clearinghouses for debit cards and for credit cards, as do American Express and Discover. Clearinghouses are also commonly used in securities and commodities futures transactions. The National Securities Clearing Corporation, the Fixed Income Clearing Corporation, and the Options Clearing Corporation clear almost all transactions in equity securities, debt securities, and equity derivatives, respectively, while each board of trade has an associated commodities clearinghouse.

47. See Adam J. Levitin, *The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445, 451–52 (2013). In other work, I have noted the price transparency benefits of clearinghouses for their members in contrast to over-the-counter dealer markets. *Id.* at 452–53.

Obviously the replacement of the counterparty risk of the original counterparty with the counterparty risk of the clearinghouse makes sense if, and only if, the clearinghouse represents a lower risk. In fact, clearinghouses do for two reasons. First, clearinghouses have informational advantages over any individual firm.⁴⁸ A clearinghouse is often able to see much more of the market than any individual firm.⁴⁹ In theory, this gives clearinghouses an information advantage that they can use to price efficiently for changes in aggregate market risk. Second, and more importantly, clearinghouses are an efficient method to reduce counterparty risk because they have deep, layered capital exceeding that of any member institution. This is not to say that clearinghouses are necessarily always well-run, but rather that they have theoretical advantages over the alternative of over-the-counter clearing through dealers or nonintermediated clearing.

The nature of clearinghouse capital can be understood by analogy to a levy designed to withstand floodwaters. The higher the levy and the more solid its construction, the more severe the flood it can withstand. So too with capital. The more capital (and the better it is), the greater losses a firm can absorb without failing.⁵⁰ While *ex ante* regulation can help reduce risk-taking and thus prevent losses, ultimately whether a firm is able to survive is a function of the amount and type of capital it has. The more capital that can be deployed as a levy against a storm surge of losses from a firm's counterparty's failure, the greater chance the firm has to survive without assistance from the government.

Clearinghouses act as levies against financial deluges. The strength of clearinghouses as levies comes from their complex and deeply layered capital structures. Whereas a normal firm has only its common equity to absorb losses, clearinghouses have many other loss absorbers. Clearinghouses typically require their members to post margin to cover their exposures as well as to finance a guaranty fund and hold members liable for capital calls. Moreover, clearinghouse members will require their own customers to post margin for their trades.⁵¹

Although the precise details of capital structures vary by clearinghouse, typical procedures will have any losses from a default by a customer of a clearinghouse member first reduced by setoff against a customer's account

48. *Id.* at 456–58.

49. Whether this is true depends on the market share of the clearinghouse and of individual firms and over-the-counter dealers.

50. While capital is often thought of as common stock or perhaps as equity interests in general, it need not be so narrowly defined, and indeed, is not in banking regulation. Long-term debt, especially subordinated debt, can be thought of as a type of capital, as a firm with long-term debt might find itself temporarily insolvent, but not necessarily illiquid, when confronted with large losses. As long as the firm is able to service its debt, the fact that it is insolvent may not matter, as the firm may be able to earn its way back into solvency.

51. See Levitin, *supra* note 47, at 462.

and any other collateral posted by the customer. If that is insufficient—or if the transaction is for the member’s own account—then the clearinghouse may engage in setoff and seize collateral from the clearinghouse member’s proprietary account at the clearinghouse and its contribution to the clearinghouse’s guaranty fund. Should that prove insufficient, the clearinghouse may apply other members’ contributions to the guaranty fund and possibly the margin posted by other members. Only if there are additional losses will the clearinghouse itself contribute some of its own funds, while making a capital call on its members, essentially recapitalizing itself.⁵²

The total financial strength of a clearinghouse is the sum of margin posted to members, margin posted by members, its guaranty fund, its own paid in capital, and its callable capital (theoretically until its members’ own capital is exhausted). Clearinghouses thereby aggregate the capital of their members making a firm that is (in theory) far stronger and more capable of absorbing losses than any individual member.

While clearinghouse structures place first loss on the defaulting member (or member’s customer), any excess losses are ultimately mutualized through the clearinghouse’s guaranty fund (and other members’ margin), mutually owned capital, and callable capital. Thus, clearinghouses mutualize extreme losses among their members.⁵³ Overall, the capital structure of clearinghouses looks like a mutual insurance system with a very high deductible. This structure is capable of absorbing significant losses, but also minimizes the moral hazard of loss mutualization by placing the first losses on the defaulting member.

II. THE SPECIAL TREATMENT OF FINANCIAL CONTRACTS

A. RATIONALE FOR THE SAFE HARBORS

The standard policy rationale for financial contracts’ special treatment in bankruptcy is that prioritization is necessary to avoid domino effect systemic risk. According to this rationale, if a debtor is unable to honor its financial contracts its counterparties would have to (1) incur the delay and corresponding market risk of the automatic stay, like other creditors, (2) wait in line for payment with other creditors (if the contract is not adequately collateralized or subject to setoff rights), (3) risk having their executory contracts cherry-picked, like other creditors, and (4) risk having their pre-bankruptcy transactions unwound, like other creditors. The result, according to the standard explanation, would be greater market uncertainty

52. *See id.* Some clearinghouses may also be able to access emergency Federal Reserve liquidity facilities.

53. *See* 7 U.S.C. § 1a(15) (2012) (defining a “derivatives clearing organization” as an entity that “mutualize[s] . . . credit risk” on transactions among its participants).

and potentially spillover liquidity problems that could metastasize into solvency problems for the nondebtor counterparties.

If one accepts this story, and believes that prioritizing finance over restructuring is a reasonable policy, then it makes sense from a systemic stability perspective to allow the nondebtor counterparties to terminate, accelerate, and liquidate their contracts, including seizing and selling any collateral, and protecting them against most avoidance actions. We might also tell a more sophisticated version of this story, namely that the safe harbors are ultimately intended to protect the money supply from impairment. The bankruptcy safe harbors⁵⁴ cover two distinct categories of financial contracts: money substitutes and credit and hedging instruments.⁵⁵ Some financial contracts, such as Treasury security repos and swaps, function as money substitutes. These contracts are supposed to be relatively risk-free as they are used for payment and collateralization and provide the lubricant for financial markets. While they are not included in traditional measures of the money supply, they are, for all practical purposes, part of the money supply.⁵⁶ Other financial contracts, such as mortgage repos, credit default swaps, and forward contracts are credit and hedging instruments. These instruments are supposed to contain real credit and market risk.

These different categories of contracts present different policy concerns. The policy concern for money substitutes is to preserve the positive market externality of liquidity. Liquidity can be preserved only if money substitutes are unimpaired. A loss allocation regime such as bankruptcy is antithetical to the preservation of liquidity. Beyond the possibility of loss allocation, bankruptcy law impedes liquidity as the automatic stay delays collection of payments, which are generally not made until a plan becomes effective or a liquidation is effectuated. Similarly, the avoidance action safe harbors help ensure the finality of transactions, which contributes to liquidity by eliminating competing claims to the transferred assets. Thus, for money substitutes, the safe harbors are intended to preserve liquidity.

In contrast, the primary policy concern for credit and hedging instruments is loss allocation. Bankruptcy already provides a loss allocation regime that successfully handles other credit instruments—such as loans—and hedging transactions without the need for the safe harbors. There is no inherent reason to treat financial contracts that function as credit and hedging instruments differently from other credit and hedging transactions.

54. 11 U.S.C. §§ 362(b)(6)–(7), (17), (27), 555–557, 559–561 (2012).

55. Professor Stephen Lubben has similarly distinguished between financing arrangements (repos) and contracts (derivatives). Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194, 197–98 (2012).

56. See Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 1 (forthcoming 2016).

Bankruptcy works as a loss allocation regime irrespective of the form of a transaction. It should not matter that a transaction happens to be in the form of a swap, repo, forward contract, or security contract, rather than a loan, asset purchase, or sale contract.

Instead, the reason to give special protection to financial contracts that function as credit and hedging instruments is because many of them are used by financial institutions that are also dealers in money substitutes. If these money dealers were impaired because of loss allocation in bankruptcy on credit and hedging instruments, it could affect the liquidity of money substitutes issued by these institutions. Thus, the policy basis for the safe harbors rests upon protecting money substitutes.

The policy concern animating the bankruptcy safe harbors is to protect the money supply, which means preserving the liquidity of money substitutes and thus the solvency of the financial institutions that create money substitutes. Yet, if the policy goal is to protect the money supply, there are superior solutions to the bankruptcy safe harbors, namely the mandatory use of clearinghouses for systemically important classes of contracts, as discussed below.⁵⁷

B. THE TENSION BETWEEN SYSTEMIC RISK POLICY AND BANKRUPTCY POLICY

While the safe harbors are intended to reduce systemic risk, they are in tension with important bankruptcy policy goals, namely maximization of the value of the debtor's assets for the benefit of all creditors, orderly liquidation, preservation of going concern value, and consistent treatment of economically equivalent transactions.⁵⁸

The safe harbors impede the maximization of the debtor's assets for the value of all creditors by depriving the debtor of optionality regarding which contracts to assume (and pay in full as post-petition administrative expense claims) and which to reject (and treat as pre-petition claims). The ability of nondebtor counterparties to terminate, accelerate, and liquidate their contracts without regard to the automatic stay means that nondebtor counterparties can effectively cherry-pick which contracts to see to maturity and which to exit at current market values.⁵⁹ In other words, the automatic

57. In other work, I present a radical, yet ultimately conservative alternative, namely, nationalization of the money creation function. See Levitin, *supra* note 56. If private financial institutions were not permitted to engage in money creation, their impairment would not matter from a systemic perspective. My nationalization proposal would require a wholesale change in the financial system. In this Article, I focus on a more discrete and, hopefully, feasible reform.

58. See, e.g., Morrison & Riegel, *supra* note 5; Skeel & Jackson, *supra* note 8.

59. Derivatives contracts written using the 1992 ISDA Master Agreement will sometimes allow an out-of-the-money nondebtor counterparty to walk away from the contract upon the debtor's filing for bankruptcy. This presents a "heads I win, tails you lose" situation for the nondebtor counterparty. The 2002 and 2014 versions of the ISDA Master Agreement do not allow the walk away option. Instead, the terminated contract is paid out based on its market value, no matter which counterparty is in the money. Some post-2002 swaps and derivative contracts

stay safe harbors mean that the debtor cannot cherry-pick contracts, but nondebtor counterparties can. Giving nondebtor counterparties this sort of optionality functions as a penalty that deprives debtors of contracts that are likely to be more valuable for the estate if held to maturity. A nondebtor's termination option also makes it difficult for a debtor with significant financial contracts to rationally plan a bankruptcy because there is too much market uncertainty regarding what its counterparties will do.

The possibility of contract termination also threatens to deprive debtors of part of their going concern value—the value that comes from the synergies of the particular combination of assets in a firm.⁶⁰ For example, consider a set of forward contracts for jet fuel that is carefully matched to an airline's anticipated fuel usage. The forward contracts may have value in other parties' hands, but their particular value as a hedge is unique to the airline, contributing to the airline's going concern value. Similarly, a credit default swap on the debt of the airline's major parts supplier functions as a type of insurance policy against supply disruptions due to the supplier's financial problems. The hedging value of that swap is particular to the airline, just as the hedging value of Julia Robert's insurance policy on her smile is particular to Julia Roberts and her future earning ability.⁶¹

Not all financial contracts contribute to going concern value—for example, an option to purchase the stock of a firm in an unrelated industry does not add any obvious going concern value beyond some notional diversification. At least some financial contracts, however, contribute to going concern value and the automatic stay safe harbors deprive the estate of this value. Even if financial contracts can ultimately be terminated by nondebtor counterparties, the delay imposed by the automatic stay gives the debtor time to maximize the value of the assets, such as by arranging to have another party novated into the contract (via assumption and assignment).⁶²

The safe harbors are also in tension with bankruptcy's fairness tenet that two transactions that are economically equivalent should be treated the

continue to be written using the 1992 documentation; the extent to which the older documentation continues to be used is uncertain. The 2002 and 2014 versions of the ISDA Master Agreement are fairer regarding the treatment of debtors in terminated contracts. Nonetheless, termination can still deprive a debtor of significant value, as termination payments are made at current market values, rather than based on market value at maturity. Termination thus relieves both counterparties of the risk of subsequent market movement, but because termination is solely the nondebtor's option, the right to terminate benefits the nondebtor counterparty, not the debtor.

60. Going concern value is the value of a firm as a going concern over and above the liquidation value of its assets.

61. *J. Lo's \$27 Million Booty, Julia's \$30 Million Smile and More Insured Star Body Parts*, PEOPLE (Mar. 18, 2015, 5:00 PM), http://www.people.com/people/gallery/0,,20908885_13,00.htm#30311261.

62. Such delay can also potentially protect nondebtor counterparties by reducing the chances of all counterparties terminating their contracts simultaneously and then flooding the market with seized collateral thereby pushing down the market price of the collateral and reducing the counterparties' recoveries.

same.⁶³ The avoidance action safe harbors undermine this principle. An unperfected secured loan may be avoided as a fraudulent transfer, but a repo may not, despite the repo being economically indistinguishable.⁶⁴ A preferential grant of additional collateral for an existing security interest may be avoided, but not if that additional collateral has been posted as margin for a swap.⁶⁵ A guaranty issued by an insolvent debtor of the payment of its subsidiary for a bank loan may be avoided as a fraudulent transfer, but not a guaranty by an insolvent debtor of the payment of its subsidiary for notes issued to underwriters in a private placement of securities.⁶⁶

Irrespective of whether the safe harbors are a good idea, they are fundamentally in tension with a range of bankruptcy policies. The prioritization of financial contracts reflects a subordination of bankruptcy policy to systemic risk policy. Accordingly, to the extent systemic risk concerns can be addressed through other policies, it is possible to eliminate the safe harbors and thus the subordination of bankruptcy policy to systemic risk policy.

C. CRITICISMS OF THE SAFE HARBORS

Existing scholarship has heavily (and rightly) criticized the financial contract safe harbors. The literature has made several critiques. First, the safe harbors are overly broad and cover contracts that do not actually present systemic risk.⁶⁷ For example, forward contracts for the sale of white fish to ensure a steady *gefilte fish* supply during Passover⁶⁸ do not seem to merit special treatment based on systemic risk considerations, yet they nonetheless receive it.

Second, the safe harbors are vulnerable to abuse because of courts' intensely literal reading of the Bankruptcy Code to elevate form over economic function.⁶⁹ Secured loans, for example, can be recast as financial

63. See Skeel & Jackson, *supra* note 8. To be sure, not all economically equivalent transactions are treated identically by bankruptcy law. For example, a sale-leaseback or a ground lease can be economically equivalent to a secured loan, but will not be treated as one (and indeed might be subject to the § 502(b)(6) claim cap on leases). 11 U.S.C. § 502(b)(6) (2012).

64. See 11 U.S.C. § 546(f). A repo is an agreement for the sale and repurchase of a security. The security is functionally collateral for a loan made by the seller, with the difference between the sale and repurchase price being equivalent to a finance charge.

65. *Id.* § 546(g).

66. *Id.* § 546(e).

67. See Skeel & Jackson, *supra* note 8.

68. See Matt A.V. Chaban, *Gefilte Fish Is Scarce This Passover. Taste Buds Are Ambivalent*, N.Y. TIMES, Apr. 14, 2014, at A1 (noting that Manischewitz, the largest producer of gefilte fish in the world, avoided a whitefish shortage in 2014 because it buys its fish a year in advance on forward contracts).

69. See, e.g., Official Comm. of Unsecured Creditors of Quebecor World (U.S.A.) Inc. v. Am. Life Ins. Co. (*In re* Quebecor World (U.S.A.), Inc.), 719 F.3d 94, 98 (2d Cir. 2013); Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329, 335 (2d Cir. 2011); QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.), 571 F.3d 545, 550–51 (6th Cir.

contracts, either as repos or as matched forward contracts.⁷⁰ Nonetheless, courts have refused to look at the economic reality of the transactions and concentrated instead on their form.

Third, some scholars have argued that the safe harbors from the automatic stay (but not from avoidance actions) for financial contracts is ineffective at reducing systemic risk and can instead have the opposite effect. The automatic stay exceptions encourage runs that can destabilize the market.⁷¹ If too many creditors terminate their contracts and liquidate their collateral at the same time, the market becomes flooded with collateral, which depresses the value of the collateral and thus creditors' recoveries.⁷² As a result, creditors actually incur *greater* losses due to the safe harbors. Likewise, the presence of the safe harbors discourages active monitoring by the creditors on financial contracts, who assume they can always grab their collateral in the event of a bankruptcy, but may thus allow the debtor to assume much more risk than they would otherwise.⁷³

Finally, the assumption of the bankruptcy safe harbors, as well as the Dodd-Frank Act, is that systemic risk resides solely within financial institutions. Yet, this is obviously not true. For example, the failure of major industrial firms like General Motors or Chrysler posed a serious threat to the United States economy not because of financial institutions' exposure, but because of the exposure of employees, retirees, and suppliers.⁷⁴ Similarly, the bailout of the nation's airlines after September 11, 2001 and the nationalization of the United States' passenger rail system in 1970 both point to the systemic importance of common carriers in the national economy.⁷⁵ The safe harbors privilege financial institutions over the real (nonfinancial) economy as a locus of systemic risk. Favoring financial institutions in this manner potentially exacerbates systemic risk when losses are shifted from financial institutions to other systemically important creditors and counterparties or when they result in the liquidation of firms essential for the smooth operation of the national economy.

2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986–87 (8th Cir. 2009); *Calyon N.Y. Branch v. Am. Home Mortg. Corp. (In re Am. Home Mortg., Inc.)*, 379 B.R. 503, 507–08 (Bankr. D. Del. 2008); *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999). *But see* *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996) (requiring beyond the plain language of the statute that a financial institution have a beneficial interest in transferred funds or securities for safe harbor to apply).

70. See Stephen L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715, 1750–51 (2014); Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 282 (2011).

71. See Edwards & Morrison, *supra* note 7, at 94.

72. See Lubben, *supra* note 7, at 331–32.

73. See Roe, *supra* note 7 (addressing avoidance action safe harbors, but focusing on the automatic stay safe harbors).

74. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 453–56 (2011).

75. *Id.* at 454, 460.

The first two criticisms suggest narrower definitions of financial contracts, rather than outright elimination of the special treatment. Implicit in these critiques is that special treatment of these contracts *is* merited to the extent that it prevents systemic risk.

In contrast, scholars who suggest that the automatic stay safe harbors actually exacerbate systemic risk, either by encouraging runs or discouraging monitoring, posit empirical claims. There is much to commend the theoretical analysis that supports these claims, as well as the experience of some specific cases, most notably Lehman Brothers' bankruptcy.⁷⁶ Nonetheless, absent empirical proof, it is impossible to definitively gainsay the finance industry's claim that the safe harbors do generally reduce risk and require, at most, tweaks. Moreover, the criticisms of the safe harbors' ineffectiveness are primarily targeted at the automatic stay safe harbors, not the avoidance action safe harbors.⁷⁷

Whereas the prior literature emphasizes either the overbreadth or the ineffectiveness of the special treatment of financial contracts in bankruptcy, this Article instead emphasizes the redundancy of the special bankruptcy treatment. To the extent that certain financial contracts present a particular elevated type of systemic risk, clearinghouses already address those risks, making the bankruptcy safe harbors unnecessary. As the following section explains, clearinghouses are not merely an alternative method of dealing with systemic risk, but are in fact a superior method to the bankruptcy safe harbors. The redundancy of systemic risk protections means that the bankruptcy safe harbors could be eliminated without increasing—and possibly decreasing—systemic risk. It is possible to have the best of both worlds: good systemic risk policy and good bankruptcy policy. Systemic risk prevention does not need to come at the expense of bankruptcy (or more generally, insolvency) policy.

III. CLEARINGHOUSES AS SUBSTITUTES FOR THE BANKRUPTCY SAFE HARBORS

A. MUTUALIZATION AS SYSTEMIC RISK POLICY

Mutualization of risk via clearinghouses is a superior method of addressing systemic risk than prioritization via bankruptcy. Mutualization spreads losses across the financial services industry, which is appropriate given the role interconnectedness plays in systemic risk.

Interconnectedness is not the only source of systemic risk, but it is an important aspect of it. This can be seen from the 2008 financial crisis. In

76. See Andrei Shleifer & Robert Vishny, *Fire Sales in Finance and Macroeconomics*, 25 J. ECON. PERSP. 29 (2011).

77. But see Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 131 (2010) (noting that the automatic stay is only effective at preventing runs on the debtor when coupled with an anti-preference provision).

2008, AIG was bailed out not because it was so important in itself, but because of the spillover risk posed to its counterparties; if AIG had failed, its swap counterparties might themselves have failed. Similarly, if Morgan Stanley had failed, its clearing bank, JPMorgan Chase might well have failed, which would have brought down the other banks, such as Goldman Sachs, that used JPMorgan Chase as their clearing bank.

Because of the interconnected nature of systemic risk, it is impossible to articulate the precise modicum of risk that is created by a particular financial institution's activities. Therefore, mutualizing the costs of systemic risk to the entire financial services industry is an entirely appropriate response.⁷⁸ Such mutualization of risk based on the scale of transactional activity will result in some internalization of systemic externalities and thereby reduce the incentive to engage in excessively risky transactions.⁷⁹ It is not a perfect or precise measure, but it is a reasonable one for addressing the systemic risk that arises from the interconnectedness of the financial services industry.⁸⁰ In any event, risk internalization within the financial services industry is far fairer than a system of prioritization that shifts risk to unadjusting, unsecured creditors, including tort and tax creditors.

By its very nature, mutualization reduces the need for bailouts. In theory with mutualization, the aggregate capital of an entire industry can be deployed to stanch losses before government funds need be deployed. And, if a bailout is necessary, it may be politically easier to bailout an entire industry, rather than a particular firm because it is easier for the public to understand the need to support a broad sector of the economy and a sector-wide bailout does not appear to play favorites or reward specific bad actors. Moreover, industry-wide bailouts let the government avoid the political problem of picking winners and losers in the market. Indeed, another of the Dodd-Frank Act's reforms attempts to prohibit individual firm bailouts under section 13(3) of the Federal Reserve Act.⁸¹

Mutualization of risk is, in general, the policy preferred by the Dodd-Frank Act. Another Dodd-Frank Act provision establishes an Orderly

78. The danger of free riding in this mutualized risk system is reduced, however, because clearinghouses impose first losses on the defaulting member (or member's customer). Only extreme losses get mutualized based on the scale of transactional activity. The concentration of first losses on the defaulting member reduces the incentive to free ride off of mutualized risk. A clearinghouse will only mutualize risk when a member (or member's customer) is insolvent.

79. Clearinghouses are also capable of pricing *ex ante* for the risk posed by its aggregate exposures to a member. This would force the internalization of some of the costs of being too-big-to-fail on those larger clearinghouse members.

80. This sort of mutualization already exists via mutual insurance funds, such as the FDIC's Deposit Insurance Fund. Contrary to popular belief, the FDIC's Deposit Insurance Fund is not guaranteed by the United States government, but is, instead, a mutual insurance fund for the financial services industry. *See* Levitin, *supra* note 56, at 25 n.49.

81. Dodd-Frank Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2113 (2010) (codified at 12 U.S.C. § 343(3) (2012)).

Liquidation Fund funded by assessments on systemically important financial institutions.⁸² The Orderly Liquidation Fund is to be used to finance the liquidation of systemically important financial institutions. Thus, systemically important financial institutions are required to finance what is essentially a mutual DIP loan fund⁸³ (or perhaps more aptly described as a required subscription to a mutual burial society).

B. MANDATING CLEARINGHOUSES FOR ALL SYSTEMICALLY SIGNIFICANT TRANSACTION CLASSES

The Dodd-Frank Act mandates use of clearinghouses only for swaps⁸⁴ and allows for regulatory exemption of certain swaps, including those undertaken by small financial institutions and hedging transactions where one of the counterparties is not a financial institution.⁸⁵ The logic of the Dodd-Frank Act, however, is not restricted to swaps. Instead, it extends to all systemically important types of financial contracts.

Many types of financial contracts already clear through clearinghouses even without a statutory requirement to do so. All commodities futures contracts go through clearinghouses affiliated with boards of trade. Similarly, all exchange-traded securities contracts clear through clearinghouses. For these contracts the bankruptcy safe harbors are already redundant. In the event a counterparty files for bankruptcy, it is the clearinghouse that will be the real creditor, not the nondebtor counterparty.

There are, however, other types of financial contracts that do not go through clearinghouses. Securities repos, mortgage repos, forward contracts (other than commodities futures), and non-exchange-traded securities contracts do not generally clear through clearinghouses.

Repos present a particularly large market in money substitute claims. Repo clearing splits into three distinct markets. First, approximately 17% of repos are partially cleared through a clearinghouse.⁸⁶ General Collateral Finance (GCF) repos are a blind-brokered interdealer market of repos collateralized by a range of Treasury and Agency securities.⁸⁷ The starting leg (the purchase transaction) in a GCF repo clears bilaterally, but the

82. *Id.* § 210; 12 U.S.C. § 5390(n)–(o).

83. A Debtor in Possession, or DIP loan, is a loan made under 11 U.S.C. § 364 to provide financing to a company in bankruptcy.

84. Dodd-Frank Act, §§ 723, 763.

85. *Id.* See also CFTC Exceptions to the Clearing Requirement, 17 C.F.R. § 50.50 (2013) (regulatory implementation of commodity-based swaps exemption). As of the second quarter of 2015, the SEC had still not promulgated a final rule for equity-based swaps clearance.

86. Adam Copeland et al., *Mapping and Sizing the U.S. Repo Market*, FED. RES. BANK OF N.Y.: LIBERTY ST. ECON. (June 25, 2012), <http://libertystreeteconomics.newyorkfed.org/2012/06/mapping-and-sizing-the-us-repo-market.html#.VV0CP2TONBc> (quotient of the sum of GCF for repo and reverse repo over the sum of all repo and reverse repo transactions).

87. Adam Copeland et al., *Key Mechanics of the U.S. Tri-Party Repo Market*, FED. RES. BANK OF N.Y.: ECON. POL'Y REV. 20 (Nov. 2012), <http://www.ny.frb.org/research/epr/12v18n3/1210cope.pdf>.

closing leg (the repurchase transaction) clears through the Fixed Income Clearing Corporation.⁸⁸ Second, another 29% of securities repos are tri-party repos⁸⁹ that clear through one of two clearing banks—JPMorgan Chase and Bank of New York Mellon.⁹⁰ 85% of tri-party repos are of Treasury or Agency securities.⁹¹ Third, the remaining 54% of the repo market is in uncleared bilateral repos.⁹² Many of these bilateral repos are reverse repos. Reverse repos are often the form by which broker-dealers make loans to their prime brokerage clients. That is, many of these uncleared repos are loans from banks to hedge funds.

Therefore, repos and all other types of systemically important financial contracts should be required to clear through clearinghouses. This includes repos of exchange-traded securities—especially of Treasury securities. Because of their roles as repo clearing banks, JPMorgan Chase and Bank of New York Mellon are singular nodes of systemic risk. Unlike clearinghouses, these clearing banks engage in a host of activities unrelated to clearing that pose a risk to their ability to honor their clearing commitments. They also lack the layered capital structure of clearinghouses.

These clearing banks are inherently too-big-to-fail because their failure would bring down the entire tri-party repo market and thus the securities lending industry. The result is to encourage excessive risk-taking by these banks. The Federal Reserve Bank of New York has worked with these banks to reduce their intraday repo exposure, but their risk has only been reduced, not eliminated.⁹³ To truly address systemic risk in the repo market these banks should be required to spin-off their clearing operations into mutual clearinghouse corporations.

Not all types of financial contracts, however, are systemically important as a class. For nonsystemically important types of financial contracts there is no reason to require the use of clearinghouses or to protect them with the bankruptcy safe harbors.⁹⁴ Thus, forward contracts for physical delivery (i.e., that are not commodities futures) are inherently bespoke contracts that

88. See Michael J. Fleming & Kenneth D. Garbade, *The Repurchase Agreement Refined: GCF Repo*, 9 CURRENT ISSUES IN ECON. & FIN. 1, 3 (June 2003), http://www.newyorkfed.org/research/current_issues/ci9-6.pdf.

89. Adam Copeland et al., *supra* note 86 (quotient of tri-party repo over the sum of all repo and reverse repo transactions).

90. Adam Copeland et al., *supra* note 87, at 21.

91. *Id.* at 20.

92. Adam Copeland et al., *supra* note 86 (quotient of the sum of bilateral for repo and reverse repo over the sum of all repo and reverse repo transactions).

93. See *Tri-Party Repo Infrastructure Reform*, FED. RES. BANK OF N.Y., http://www.newyorkfed.org/banking/tpr_infr_reform.html (last visited Nov. 10, 2015).

94. The American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 has similarly proposed excluding “ordinary supply contracts” from the safe harbors. AM. BANKR. INST., COMM’N TO STUDY THE REFORM OF CHAPTER 11, FINAL REP. & RECOMMENDATIONS 107 (2015). The ABI Commission’s proposal applies to “nondealer counterparties to physical supply contracts.” *Id.*

do not pose systemic risk implications in any individual bankruptcy because of their limited scale. If Manischewitz is not able to terminate, accelerate, and liquidate its forward contract for whitefish, the skies will not fall any more than if a large public utility company has to wait through a bankruptcy before collecting on its forward contract for electricity generation. Similarly, private-placements of securities do not pose any greater systemic risk than syndicated leveraged loans, which are not covered by the safe harbors (and indeed, the syndicated leveraged loans might in fact be more liquid in secondary markets). Lastly, bilateral mortgage repos—the preferred funding vehicle for nonbank subprime lenders—are just secured warehouse lines of credit with collateralized mortgages. There is nothing inherently systemic about these secured loans.

There is a fairly easy test of determining which contracts are systemically important and should be cleared via clearinghouses and which are not. Central clearing is only practical on relatively common and homogeneous financial instruments, such as the Treasury and Agency securities accepted as GCF. This is because it is too difficult and costly for a clearinghouse to accurately price and margin bespoke contracts. To the extent that financial contracts are not sufficiently homogeneous and common for central clearing to be practical, these contracts are unlikely to present a systemic risk.

While such heterogeneous contracts can individually and collectively reflect large positions, such as JPMorgan Chase's infamous multi-billion "London Whale" trade,⁹⁵ they are unlikely to be systemically important precisely because they are heterogeneous. Problems with heterogeneous contracts are unlikely to result in liquidity-contracting panics because markets recognize that the contracts are unique. Such heterogeneous contracts are already themselves illiquid and therefore not exposed to liquidity risks, just as they are unlikely to suffer from correlation risk because they are unique.

By way of analogy, heterogeneous contracts are like a genetically diverse population. Such a genetically diverse population is more likely to avoid a catastrophic collapse when confronted with a pathogen than a homogenous population. The entire homogenous population either has immunity to the pathogen or it does not. If it does not, the entire population might be wiped out. It is a binary outcome. In contrast, immunity will vary within the genetically heterogeneous population. While there might be mortality in the heterogeneous population, it is less likely to have complete mortality than a homogeneous population. The same is true of contracts. Homogeneous contracts have correlation and liquidity risks that do not exist for heterogeneous contracts.

95. See Patricia Hurtado, *The London Whale*, BLOOMBERG (Apr. 23, 2015, 12:09 PM), <http://www.bloombergview.com/quicktake/the-london-whale>.

Heterogeneous contracts thus might actually be collectively safer—that is systemically safer—than homogenous contracts. Accordingly, there is no good policy reason to give these contracts special treatment in bankruptcy. The universe of mandatory clearing should match the universe of systemically significant transaction classes. Thus, we come to a situation in which systemically important contracts should be cleared through clearinghouses and nonsystemically important contracts should be left uncleared. Neither systemically important nor systemically unimportant contracts should benefit from special treatment in bankruptcy because the distortionary effects of the special treatment are unnecessary to achieve the policy goal of reducing systemic risk.

C. CLEARINGHOUSE RISK AND REGULATION

When a clearinghouse is used to clear a contract, it becomes the debtor's counterparty to the contract as of the "acceptance date" when the clearinghouse is novated to the contract.⁹⁶ From that point on, if the debtor files for bankruptcy, it is the clearinghouse that is the creditor. The systemic risk reduction argument for the bankruptcy safe harbors does not apply to clearinghouses when they stand as creditors. This is because of clearinghouses' deep, layered capital and access to emergency liquidity sources. A clearinghouse can afford to absorb the losses caused by delay and even debtor cherry-picking, as those losses will ultimately be mutualized among its members. The clearinghouse is likely to have additional protection from margin posted by the debtor for all contracts and from common law rights of setoff (without need for a master netting agreement).⁹⁷ Therefore, even if a clearinghouse member were to fail, the clearinghouse's net exposure would likely be substantially smaller than the aggregate of the member's positions.

Similarly, clearinghouses do not need the benefit of the avoidance action safe harbors. It is unclear whether a clearinghouse would have liability for avoidance actions, even in the absence of the safe harbors. In many instances, they are secondary transferees that take in good faith for value or tertiary good faith transferees.⁹⁸ In some situations the clearinghouse might be the formal initial transferee, but given that it has no more than momentary beneficial ownership of the transferred property, its

96. Acceptance dates are often only shortly before payment is due, but there is no inherent reason that has to be the case. Extending acceptance dates farther out would impose more risk on clearinghouses by increasing the period for which they would have liability on the cleared contracts and would require more margin/higher pricing, but that is not an inherent problem, as it is a risk that could be priced.

97. Conceivably, however, to make the setoff right meaningful, clearinghouses might require a limited safe harbor under the Bankruptcy Code to allow them to engage in triangular setoff or other types of "sloppy" setoff without regard to the particular identities of counterparties within a corporate group, if they would have the right to do so under non-bankruptcy law.

98. See 11 U.S.C. § 550(b) (2012).

role in the transaction might well be disregarded.⁹⁹ In any case, to the extent a clearinghouse had liability for an avoidance action, it would presumably be indemnified by the nondebtor counterparty because clearinghouses are in no position to undertake diligence of individual transactions.¹⁰⁰

While clearinghouses are systemic risk absorbers with deep, layered capital, they are also concentrated nodes of risk within the financial system, and, if poorly managed, can increase systemic risk.¹⁰¹ Indeed, clearinghouses can themselves become too-big-to-fail.

The too-big-to-fail problem is less concerning for clearinghouses, however, for several reasons. First, the deep capital of clearinghouses makes them much less likely to fail from credit losses than any individual institution. In theory, a clearinghouse can call on all of the capital of its members. Thus, strong institutions support the weak through the clearinghouse.

The real risk with clearinghouses is operational risk, not credit risk. If a clearinghouse's computer system went down or malfunctioned and the clearinghouse failed to timely perform on its obligations, it could incur significant liability. Operational risk affects all institutions, and can conceivably be covered by insurance, but clearinghouses do pose a magnified risk of operational failure.¹⁰² Access to the Federal Reserve's discount window for clearinghouses designated as systemically important lessens the risk of a clearinghouse operational failure causing a systemic crisis.¹⁰³

Second, clearinghouses are not leveraged institutions. Clearinghouses are not generally borrowing funds, although they do often have revolving lines of credit, but are instead running matched books of highly liquid contracts.¹⁰⁴ Accordingly, clearinghouses are much less likely to become insolvent than individual leveraged firms, such as banks or broker-dealers.

99. While clearinghouses, like the Federal Reserve's FedWire system, have been treated as real intermediaries for the purposes of section 546 jurisprudence, that section of the Bankruptcy Code is bound by its language and the associated broad definitions. Section 550, in contrast, uses the undefined term of "transferee." A court might well look at the economic reality of the transaction and consider a clearinghouse a pass-through entity to be disregarded, much as the Eleventh Circuit's minority jurisprudence on section 546 holds. *See* *Munford v. Valuation Research Corp.* (*In re* *Munford, Inc.*), 98 F.3d 604, 610 (11th Cir. 1996).

100. In this regard, clearinghouses raise a similar issue to claims trading.

101. *See* Levitin, *supra* note 47; Mark J. Roe, *Clearinghouse Overconfidence*, 101 CAL. L. REV. 1641 (2013) (arguing that clearinghouses may increase systemic risk by pushing it outside the realm of cleared transactions).

102. *See* Huberto M. Ennis & David A. Price, *Discount Window Lending: Policy Trade-offs and the 1985 BoNY Computer Failure* (Fed. Res. Bank of Richmond, Econ. Brief 15-05, 2015), https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-05.pdf.

103. *See* 12 U.S.C. §§ 5463, 5465 (2012).

104. *See* Richard Squire, *Clearinghouses as Liquidity Partitioning*, 99 CORNELL L. REV. 857 (2014). If the revolver is with a member that fails, the revolver will not be available to provide liquidity to the clearinghouse, but clearinghouses designated as systemically important can access the Federal Reserve's discount window. *See* 12 U.S.C. §§ 5463, 5465.

Third, because clearinghouses are mutuals with callable capital, they price solely to cover risk, not to generate a profit. This means that clearinghouses lack the lopsided incentive for excessive risk-taking created by limited shareholder liability. It also means that clearinghouses are capable of pricing for the counterparty size. The larger a clearinghouse member is, the greater the risk to the clearinghouse from that individual member failing. This incentivizes clearinghouses to price adversely for member size, essentially creating a market-based too-big-to-fail penalty on larger financial institutions. Such pricing would reduce clearinghouse members' incentive to be large in order to capture too-big-to-fail benefits.

Fourth, it is technically easier to bail out a clearinghouse than other financial institutions. While bailouts are disfavored, they are nonetheless an important tool for addressing systemic risk—not all of which can be eliminated through *ex ante* regulation.¹⁰⁵ Accordingly, the feasibility of bailouts is an important consideration when evaluating the systemic risk posed by an institution.

It is easier to bailout clearinghouses because they have simpler corporate and financial structures than other financial institutions. A clearinghouse's obligations are basically limited to the contracts it clears; the clearinghouse is not leveraged. There are not complicated regulatory or contractual issues to navigate when recapitalizing a clearinghouse. Nor is there a business model problem if a clearinghouse fails. A clearinghouse will fail because it misprices for the risk it assumes, but for no other reason. Thus, there are relatively few operational issues to address with a failed clearinghouse.

Finally, it is much easier politically to bail out a failed clearinghouse because it is essentially a utility that benefits an entire sector of the economy, rather than a privately owned firm. A clearinghouse will only fail after its members have already kicked in additional capital, and at that point a government bailout is appropriate, as it is about ensuring continued economic stability, rather than benefitting private parties.

Still, ensuring that clearinghouses are well managed and provide fair and equal access for all parties is critical if they are to be relied upon to reduce systemic risk.¹⁰⁶ A system based on poorly regulated clearinghouses is a recipe for disaster. Accordingly, a major regulatory task is designing a prudential regulatory system for clearinghouses that will ensure that clearinghouse governance prioritizes risk management, rather than expansion of market share. How to optimize clearinghouse governance and risk management is beyond the scope of this Article.

105. See Levitin, *supra* note 74, at 439–40.

106. See Levitin, *supra* note 47, at 466.

CONCLUSION

The existence of clearinghouses for systemically important types of financial contracts renders the bankruptcy safe harbors for financial contracts redundant. Clearinghouses represent a superior method of addressing systemic risk concerns than the safe harbors because they are an efficient and fair risk transfer device. Clearinghouses' ability to aggregate capital across the financial services industry makes them better suited for absorbing losses than any individual firm and their ability to price for scale of exposures and mutualization of losses according to scale of transactional activity helps ensure the internalization of systemic externalities. This Article has proposed eliminating the bankruptcy safe harbors for all financial contracts. All systemically important contracts should be cleared via clearinghouses. Those contracts that are not susceptible to centralized clearing are not systemically important and therefore not deserving of the privileged bankruptcy treatment.

Eliminating the safe harbors would undo the subordination of bankruptcy policy to systemic risk policy. It would also undo the potentially counterproductive effects of the safe harbors, namely the encouragement of runs, fire sales, the discouragement of creditor monitoring, and the prioritization of financial creditors over potentially more critical real economy creditors. With the enactment of the Dodd-Frank Act's swap clearing mandate, there is no longer a good justification for the bankruptcy safe harbors for financial contracts. It is time to eliminate the safe harbors entirely and to mandate that the few remaining types of uncleared, but systemically important contracts—such as securities repos—be placed on clearinghouses.